



STATEMENT FOR THE RECORD

Committee on Ways and Means Hearing on Tax Reform and Consumption-Based Tax Systems

**Submitted by the American Manufacturing Trade Action Coalition
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The mission of the American Manufacturing Trade Action Coalition (AMTAC) is to preserve and create American manufacturing jobs through the establishment of trade policy and other measures necessary for the U.S. manufacturing sector to stabilize and grow. Among other companies, AMTAC represents a substantial portion of the U.S. textile industry.

Introduction – Solving Manufacturing Crisis Requires Tax Reform

Manufacturing provides millions of American jobs, enables a diverse workforce, and sustains communities and families in both urban and rural America. It also contributes an irreplaceable component to the nation's gross domestic product (GDP) and is vital to the armed forces and overall national security of the United States.

The crisis that has engulfed American manufacturing in the first decade of the 21st century is historic and unprecedented since the Great Depression. It places both our national and economic security at risk.

The crisis has cost the U.S. economy almost 5.5 million manufacturing jobs, many major company bankruptcies and thousands of plant closures. In addition, the hemorrhage in the U.S. manufacturing sector has had a ripple effect throughout the economy due to the fact that several other non-manufacturing jobs are lost for every single manufacturing job lost.

In addition, the crisis is manifested in America's unsustainable current account deficit. The \$5.8 trillion deficit of the last decade represents the standard of living desired by Americans compared to the shortfall in wealth that we have produced. The combined trade deficits of \$5.6 trillion in manufactured goods and of \$1.7 trillion in oil and gas exceed America's entire current account shortfall. To finance our consumption, America has been forced either to borrow from or sell assets to foreign interests at a rate of nearly \$1.6 billion per day.

Consequences of this huge deficit include markedly slower U.S. economic growth, skyrocketing public and private debt, havoc with the lives of individual Americans and their families and communities, a weakening of the underlying strength of the dollar, large capital inflows for additional production capacity in low-wage nations, increasing foreign ownership of U.S. assets and companies, and the condoning of pollution, unfair labor and other reprehensible production practices around the globe.

A single policy problem is not responsible for the fix that the U.S. economy is in and a single solution will not solve the problem. To turn the economy around, AMTAC believes a comprehensive overhaul to U.S. trade policy is needed among other policy changes. A sound trade policy overhaul would include, but not be limited to, the rejection of flawed free trade agreements like the U.S.-Korea Free Trade Agreement (KORUS), enactment of strong anti-currency manipulation legislation, strengthened Buy-American laws, repeal of “first sale” treatment for the purpose of determining the basis to apply duties, and more effective customs enforcement.

Another key component of the necessary overhaul is embedded in the subject of this hearing – tax reform that would make U.S. producers more competitive by eliminating the disadvantage caused by foreign border-adjusted taxes.

The Foreign VAT Problem and Its Scope

Virtually all of our foreign trade competitors maintain border-adjusted tax regimes that significantly disadvantage U.S. manufacturers and service providers. Commonly referred to as value-added taxes (VAT) or goods and services taxes (GST) (from now on VAT and GST are simply labeled “VAT”), they give our overseas competitors a material advantage over their U.S. competitors.

The VAT is a general, broad-based consumption tax that is assessed on the incremental value added to goods and services at each phase of production. It applies more or less to all goods and services that are bought and sold for use or consumption in the nations that use a VAT.

Foreign countries with VATs rebate those taxes whenever their manufacturers export products to the United States. In addition, these foreign countries also apply VAT taxes on products shipped to their market. Foreign governments compound the disadvantage to U.S. producers by applying value added taxes on all costs associated with exports into their market such as freight, insurance and tariff costs in addition to the actual value of the exported item. In contrast, the United States does not have a VAT or any other border tax system. The United States does not apply any similar federal taxes to goods shipped to our market from a foreign competitor. Nor do U.S. exporters receive any tax rebates when they ship products to foreign markets.

As a result, the 150+ countries that use border-adjusted tax regimes heavily subsidize their exports while at the same time erecting massive trade barriers to U.S. goods. Through a combination of foreign export subsidies and import assessments, it is estimated that foreign border tax schemes resulted in a \$518 billion disadvantage to U.S. manufacturers and service providers in the year 2008.

To appreciate the enormity of this problem, the \$518 billion border tax problem was 2.8 times more costly in 2008 than the estimated \$185 billion spent on wars in Iraq and Afghanistan. Moreover, the border tax problem was nearly two times greater than the entire U.S./China trade deficit which reached \$266 billion in 2008.

The Origin of the Foreign VAT Problem

Noting that VAT regimes place U.S. producers at a significant disadvantage in the global marketplace, it is essential to review the history of value-added taxes. Moreover, it is important to understand how global trading rules have come to sanction this massive, trade-distorting loophole contrary to GATT/WTO founding principles.

Shortly after the conclusion of World War II, the General Agreement on Tariffs and Trade (GATT), the precursor to the World Trade Organization (WTO), was established in 1947. The original purpose of the GATT was to facilitate international trade through the establishment of fair and transparent rules. In order to meet this fundamental objective, it was critical for the GATT to assure that countries' tax systems would be treated in a manner that was trade neutral. At the time, countries employed both direct and indirect tax systems, the two major categories of taxation.

- Direct Taxes (such as property or income taxes) are taxes that cannot be shifted onto others. These taxes are paid by the individual generating income or possessing property.
- Indirect Taxes (such as excise or value-added taxes) are taxes that are shifted onto another party, generally onto a consumer as a component of the price paid for goods or services.

Failure to properly address these differences would have allowed tax systems to serve as de-facto subsidies or trade barriers. However, at the inception of the GATT members held little more than general discussions on tax-related subsidies as an issue of concern. These initial discussions led only to general notification and consultation requirements as opposed to firm definitions of prohibited subsidies. Consequently, there was no definition of a prohibited export subsidy included in the 1947 Agreement.

In 1955, GATT members agreed to ban export subsidies to manufactured goods. However, the 1955 amendment included an interpretive note to Article XVI which provided that the "exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." In other words, indirect taxes such as a VAT could be rebated to manufacturers who exported their goods. At the time, indirect tax systems were not widespread and typically had quite small tax rates.

In 1960, based on a proposal put forward by France, GATT members approved a Working Party report that identified a detailed but non-exhaustive list of prohibited export subsidies. The report specified that the rebate or deferral of direct taxes on exports

was considered a prohibited export subsidy (now codified in Annex 1 of the Agreement on Subsidies and Countervailing Measures). At the same time, the GATT allowed the rebate of indirect taxes (such as value-added taxes) on exports and also the collection of value-added taxes on imports. Because indirect tax rates were generally low, the U.S. underestimated the impact of allowing disparate treatment of different tax systems under GATT rules.

Economists, however, quickly recognized the potential for trade distortion. For example, M.I.T. Professor Charles Kindleberger, writing in 1963 when France had its TVA (or VAT) system operating as both an export subsidy and an import penalty, but Germany did not, said: "...German sales to France get taxed twice, once by Germany and once by France, whereas French exports to Germany escape tax in both jurisdictions... This distorts production in favor of France and against Germany..." Today that distortion does not exist between France and Germany, but it does favor the 150+ countries with VATs and disadvantages the U.S. when we trade with them.

The series of GATT decisions on the definition of export subsidies resulted in a severe distortion in global competition that would grow as more countries adopted indirect tax systems over time. In addition, countries also substantially increased their indirect tax rates, in some cases at rates comparable to the reductions in import duties required from GATT negotiations. These critical GATT articles and decisions include the following:

- GATT Articles II & III -- The application of indirect taxes, such as value-added taxes to imports are allowable and such taxes are not considered as part of a country's bound duty rates. [1947]
- GATT Article XVI -- Rebates of indirect consumption taxes, such as value-added taxes on exports are not considered export subsidies. [1947]
- GATT Article VI -- Anti-Dumping and Countervailing Duty (CVD) duties may not be imposed to counteract the rebate of such taxes on exports. [1955]

Moreover, in 1979, the prohibition of rebates and remission for direct taxes and the permissibility of exempting or rebating indirect taxes were incorporated into the Tokyo Round Subsidies Code through inclusion in the Illustrative List of Export Subsidies. In 1994, that list was carried over to the Uruguay Round Agreement on Subsidies and Countervailing Measures.

In sum, these rulings allowed GATT trading partners to rebate value-added taxes on their exports, and to also collect value-added taxes on imports. GATT rules were also structured to prohibit such border adjustments for direct taxes like the U.S. corporate income tax. Although these decisions clearly presented a substantial advantage to countries operating indirect tax systems (such as VAT), U.S. representatives to the GATT failed to object in the 1950s to the discrimination created for two main reasons.

1. Indirect taxes were not major taxes in most countries and therefore were viewed as a minor nuisance.

2. The U.S. was by far the dominant industrial superpower during this post-World War II period. Operating under a Marshall Plan mentality, U.S. foreign policy was to pursue measures helpful to other countries even at considerable sacrifice to itself. In that light, approval of the indirect tax loophole under GATT was viewed as a necessary concession designed to bolster the economies of key strategic allies.

In retrospect, the failure to classify VAT rebate schemes as an unfair subsidy within the context of the GATT has proven to be a monumental error on the part of U.S. trade negotiators. Upon confirmation that the rebate of indirect taxes would not be considered a subsidy under the GATT and with the ability to apply indirect taxes to the full value of imports at the border, virtually every major participant in the global trading arena adopted indirect tax schemes, predominantly VAT-type systems. While many countries had indirect tax systems in place at the initiation of the GATT, no country had a VAT in 1947. France was the first country to implement a VAT system in 1948, which they called the TVA (*tax sur la valeur ajoutée*). No other country had a VAT until 1960. Consequently, it is no surprise that VAT schemes were not initially identified by political leaders in the U.S. as a major problem. Today however, including France, there are 150+ countries that now have some type of VAT arrangement. This list includes all of Western Europe along with key trading partners such as China, India, Brazil, Japan, Taiwan, Vietnam and South Korea.

Not only has there been an exponential growth in the number of countries that now utilize a VAT, the actual rate of the tax applied by these countries is not regulated by the WTO. Consequently, countries are free to increase their value-added taxes to whatever level they desire, regardless of the distortion on international trade flows. In practice, it appears that the trend has indeed been for countries to raise their standard VAT rates over time. For example, France started with a VAT rate in the late 1940s of 2 percent and today has a rate of almost 20 percent. The average border tax rate for all VAT countries is in excess of 15 percent.

All of these countries recognize that a VAT gives their manufacturers and exporters a dramatic competitive advantage. For some, like the members of the European Union, declines in applied tariff rates have been mirrored by increases in standard VAT rates, such that the total charges to imports from a country like the United States are remarkably similar today to what they were forty years ago despite declining tariffs.

In addition, VAT rates are typically applied on a landed cost, duty-paid basis, meaning the tax is imposed not just on the price of the good from the U.S., but also on movement charges from the U.S. to the importing country and on the duties that are charged on importation. At the same time, imports into the U.S. from countries with VAT systems have been freed of the VAT imposed in country, resulting in massive refunds (or tax liability reductions) to exporters. Moreover, the U.S. applies duties on the simple value of the imported product as opposed to the value plus all transportation, insurance and handling charges. Since the U.S. does not impose a national-added tax at the border and does not rebate taxes to exporters, U.S. producers are disadvantaged in export markets and in our own domestic market when competing against imports from a VAT country.

U.S. Reaction to the Proliferation of Foreign VAT Subsidies

As noted above, the United States made a major negotiating blunder in approving an exemption for value-added taxes under the GATT and its successor, the World Trade Organization (WTO), subsidy provisions. The U.S. has compounded this serious error over the ensuing decades through further missteps and a failure to correct this problem although explicitly instructed to do so by Congress on several occasions.

As more countries adopted a VAT in the 1960s, U.S. dominance in the global marketplace began to fade. The unfair advantage garnered through the indirect tax (VAT) loophole was specifically identified as a key aspect of our growing international trade problem. The following is a quote from President Johnson in 1968:

American commerce is at a disadvantage because of the tax systems of some of our trading partners. Some nations give across-the-board tax rebates on exports which leave their ports and impose special border tax charges on our goods entering their country. ... I have initiated discussions at a high level with our friends abroad on these critical matters...

-- Statement by the President Outlining a Program of Action to Deal with the Balance of Payments Problem. January 1, 1968.

Despite President Johnson's decision to initiate "high level" discussions, no progress was made on this issue during his Administration. In the 1970s, the U.S. began to sustain consistent trade deficits. At that time, Congressional reviews specifically acknowledged the impact of the VAT loophole on U.S. producers.

...the failure [of the U.S.] to appreciate the consequences of excluding the so-called 'indirect tax' rebates in 1960 from the general [GATT] prohibition against export subsidies while including a specific prohibition against rebating 'direct taxes', was a major blunder ... Giving away commercial advantages to prosperous Europe for the sake of their own internal tax harmonization objectives was an unwise and costly move, in which vague political objectives out-weighted clear commercial considerations.

-- Senate Finance Committee Staff Report on the Trade Reform Act of 1973

Noting the blatant unfairness of the VAT loophole and in response to growing industry concerns, Congress has repeatedly instructed the Executive Branch to negotiate a remedy to the differential treatment of direct and indirect taxes under the GATT/WTO. The following are examples of provisions included in three trade bills that were passed and signed into law.

1974: Trade Act directed the President to seek to revise GATT articles "to redress the disadvantage to countries relying primarily on direct rather than indirect taxes for revenue needs."

1988: Trade Act included nearly identical language as a principal negotiating objective.

2002: Trade Promotion Authority included a similar negotiating objective to revise WTO rules to “redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes.”

Despite these Congressional mandates, the U.S. government has to date failed to remedy the distortions caused by the GATT’s differential treatment of indirect tax systems such as the VAT, since it was first identified as a significant problem by President Johnson. In each ensuing GATT/WTO negotiation, U.S. negotiators raised the issue, but little if any serious discussion or negotiations appear to have occurred. As an example, in the Doha Round of WTO negotiations, the 2003 U.S. proposal to the Rules Group states:

... an essential part of the work of the Rules Group should be to work toward greater equalization in the treatment of various tax systems The current distinction [between direct and indirect taxes in the SCM Agreement] risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors operating under a direct taxation system.

Although there have been a decade of negotiations under the Doha Round, absolutely no progress has transpired on the above proposal or VAT issue in general. This is demonstrated by the fact that no country has presented suggested language changes to Article XVI or the Subsidies Agreement to eliminate the distortions. Nor have any proposals been put forward to redress the massive disadvantage faced by countries that do not utilize VAT systems, such as the U.S.

The failure to remedy the VAT loophole is compounded by the fact that the GATT/WTO has overturned every revision to the U.S. tax code designed to eliminate these inequalities.

DISC: In 1971, a partial tax deferral system for U.S. exports, called the Domestic International Sales Corporation (DISC), was approved by Congress. European communities challenged DISC under the GATT in 1974. Although a GATT panel ruled that it was a prohibited export subsidy, the U.S. blocked adoption until 1981 after reaching an understanding with the European countries. The U.S. subsequently committed to dismantling the DISC.

FSC: In 1984, Congress repealed the DISC program and replaced it with the Foreign Sales Corporation (FSC). In 1997, after having been in force for 13 years, the European countries challenged the FSC, and it was struck down as a prohibited export subsidy by a WTO panel in October 1999. The decision was affirmed by the Appellate Body in February 2000.

ETI: In April 2000, the U.S. announced that it would comply with the WTO rulings but would also ensure that “U.S. exports are not disadvantaged in relation to their foreign counterparts.” In November 2000, Congress enacted the Extraterritorial Income Exclusion Act (ETI) to replace the FSC. Europe immediately sought

consultations and then challenged the ETI at the WTO. In August 2001, a WTO panel ruled that the ETI was a prohibited export subsidy, and the Appellate Body affirmed the decision in January 2002. The U.S. delayed addressing the WTO ruling, and in 2004 began applying retaliatory tariffs that would have eventually totaled over \$4 billion.

JOBS Act: Enacted in October 2004, the American JOBS Creation Act (JOBS Act) repealed the ETI tax benefits, but it also allowed certain benefits to continue over a transitional period. In November 2004, the European Commission requested consultations regarding the transition provisions. A dispute panel was established in February 2005, and, in September 2005, the panel ruled that the prohibited FSC/ETI subsidies were maintained through the transitional provisions. The U.S. appealed but the Appellate Body affirmed the panel in February 2006. Based on the ruling, the European Union threatened to reimpose sanctions, and Congress passed a bill eliminating the “grandfather” provisions.

Consequently, the GATT/WTO by its terms and through its decisions has established a playing field on taxation issues that is seriously disadvantageous to US manufacturers, farmers and service providers.

The indirect tax loophole which was once viewed as nothing more than a minor irritant by U.S. trade negotiators has evolved into a hugely significant impediment to U.S. exports and the most extensive non-actionable subsidy for foreign manufacturers who ship their goods to the U.S. Until the United States makes this issue a top priority, the existing trade disadvantage for U.S. producers will not only remain in place, but will almost certainly grow worse.

The GATT/WTO articles and decisions allowing the rebate of indirect taxes, most notably today value-added taxes, to be exempt from actionability as a subsidy while also permitting such taxes to be added at the border to the full value of imports has created a fundamental imbalance within the international trading arena. U.S. exports face high costs in the forms of indirect taxes on importation and U.S. producers of all goods face subsidized competition in the U.S. market with no existing remedies to offset the advantages provided. Strangely, a system designed to level the playing field through reducing barriers to trade has managed to negatively skew the playing field against the U.S. and other economies which do not rely on indirect taxes.

The existence of the VAT loophole clearly violates the original intent of the GATT, which was to ensure that international trade would be governed under a set of transparent rules that would negate unfair advantages. In short, the original purpose was to establish a more level playing field for trade between nations. As it has evolved, the use border tax inequities, such as the VAT regimes, in other countries has allowed them to maintain massive trade distorting export subsidies and import barriers. Such regimes exist to the profound disadvantage of countries like the United States as can be seen.

A Generic Example of the Foreign VAT Disadvantage

Below is an analysis produced by the law offices of Stewart and Stewart in 2010 of a generic example of the foreign VAT disadvantage:

- A hypothetical German exporter can sell the same car for 9% less in the U.S. due to differential tax treatment – a U.S. exporter must charge 26% more on the same car exported to Germany to recoup its costs.
- The German producer enjoys a \$2,648 price advantage on its export to the U.S., while the U.S. producer bears a \$7,674 penalty on its export to Germany.

	German Car		U.S. Car	
	Domestic Sale	Export to U.S.	Domestic Sale	Export to Germany
Factory Price	\$30,000	\$25,210	\$30,000	\$28,571
Indirect Taxes in Country of Origin	19% VAT Included in Factory Price	19% VAT Refunded, Not Included in Factory Price	5% Sales Tax Included in Factory Price	No Sales Tax Assessed
Cost, Insurance & Freight Charges		\$209		\$209
Duties		\$630 (2.5%)		\$2,878 (10%)
Landed Cost, Duty-Paid Price		\$26,049		\$31,658
Indirect Taxes in Destination Country		5% Sales Tax		19% VAT
Total Price to Consumer	\$30,000	\$27,352	\$30,000	\$37,674
	Price Advantage for German Car vs. U.S. Car in the U.S.	\$2,648	Price Penalty for U.S. Car vs. German Car in Germany	\$7,674

What Can Be Done to Offset the Foreign VAT Disadvantage?

While AMTAC is not prepared to endorse a VAT at this time, it is clear that the detrimental impact of foreign VATs must be offset. AMTAC has endorsed H.R. 2666, the Border Tax Equity Act, legislation introduced by a member of the Committee on Ways and Means, Cong. Bill Pascrell that would accomplish this goal. The bill is straight-forward and its provisions include:

Declaration of congressional policy that instructs USTR to negotiate a settlement within the WTO: Congress deems it critically necessary that the issue of border taxes be addressed and resolved during current or future WTO negotiations. If such WTO negotiations fail to achieve the United States trade negotiating objective of revising WTO rules with respect to the treatment of border taxes in order to redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes, then effective action through legislation is warranted given the massive and inequitable distortions to trade that United States agricultural producers, manufacturers, and service providers face as a result of border taxes.

Report: After 60 days upon completion of WTO negotiations or by January 1, 2013, whenever is earlier, USTR must certify to Congress whether negotiating goals in our trade law mandating equitable border tax treatment for goods and services have been met.

Import tax: If these goals are not met by a date certain, a tax is imposed on imports from countries that rebate indirect taxes, like the VAT, upon the export of goods and services.

- The amount of tax imposed on the imported good or service by the United States is equal to the amount of tax rebated by the exporting country.
- Import taxes are paid into a special account.
- Importer pays the import tax.
- Tax remains in effect until USTR certifies that negotiating goals have been met.

Payment to U.S. exporters: Neutralizes the discriminatory effect of border taxes, like the VAT, by compensating U.S. exporters.

- The amount paid by the U.S. government to the U.S. exporter is equal to the amount of indirect tax imposed on the U.S. good or service by the importing foreign country at their border, minus any U.S. taxes rebated upon export of the good or service.
- Payments to services exporters begin January 1, 2012; payments to goods exporters begin upon the failure to meet negotiating goals by a date certain.
- Payments remain in effect until USTR certifies that negotiating goals have been met.

WTO consistency: This Act grants the U.S. government sufficient time to achieve these negotiating goals in WTO negotiations and gives U.S. negotiators important added leverage with trading partners. The bill authorizes both an import tax and payments to U.S. exporters to eliminate the discriminatory effect of disparate border tax treatment only in the event that negotiations are unsuccessful. Under current WTO rules, equalizing compensation to U.S. exporters of services is already WTO-legal. Thus,

earlier implementation of this provision helps to promote achievement of U.S. negotiating objectives on border equity tax.

Conclusion

If the United States truly wants to fix our runaway trade deficit, maintain our remaining manufacturing base, and preserve the critical middle class jobs provided by this manufacturing base, the U.S. government must fix international trade rules that have so generously and unfairly allowed our foreign competitors to develop and capitalize on their \$518 billion border tax advantage. The time for action is now.